

Mitigating Risk in the Merchant Cash Advance Industry

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- ▶ Leader of the Consumer Financial Services and Bank Regulatory Practice
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- ▶ Transactional practice focuses on representing financial institutions, corporations and other entities in complex financing transactions, including mergers and acquisitions, asset securitizations and other lending and venture transactions
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- ▶ Extensive experience in banking, lending, safety and soundness, and anti-money laundering. His work in regulatory compliance at large financial institutions has been marked by innovations that resulted in fundamental structural changes to existing firm-wide compliance activities, including with respect to regulatory change management, risk assessments, and vendor management.
- ▶ Handles the negotiation of agreements between non-bank lenders and regulated banks, and has represented both banks and non-bank parties to such relationships. Mr. Dabertin has authored numerous articles regarding the online lending industry
- ▶ Is an officer of the Alternative Finance Bar Association and frequently handles transactional matters concerning merchant cash advance.

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Audio

The screenshot displays the Cisco Webex Events interface. At the top, the title bar reads "Cisco Webex Events" with standard window controls. Below the title bar is a menu with "File", "Edit", "View", "Communicate", "Participant", "Event", and "Help". The main content area shows a video player with a red text overlay: "Audio should stream automatically on entry through your computer speakers". Below this, a banner for "Pepper Hamilton Webinar" is visible. At the bottom of the video player, there is a logo for "Pepper Hamilton LLP Attorneys at Law".

On the right side, a "Participants" panel is open, showing a list of participants under "Panelist 1" and "Attendee". The host, Brian Dolan, is listed as "Brian Dolan (Host)" and "Brian Dolan (me)".

An "Audio Broadcast" control window is overlaid on the bottom of the video player. It displays "24.7 Kbps" and has "Pause" and "Stop" buttons. A grey arrow points from the red text overlay to the "Audio Broadcast" window.

At the bottom of the interface is a toolbar with icons for mute, video, chat, and other functions. The "Mute" icon (a blue circle with a white microphone) is highlighted.

Audio

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File Edit View Communicate Participant Event Help

Cisco Webex Events

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Brian Dolan (Host)

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Audio Broadcast

24.7 Kbps

Pause Stop

BD

Brian Dol... (Host)

BD

Brian Dolan (me)

Q&A

Q&A

Cisco Webex Events

File Edit View Communicate Participant Event Help

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Brian Dolan (Host)

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Audio Broadcast
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Pause Stop

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Participants

- Panelist: 1
 - BD Brian Dol... (Host)
- Attendee:
 - BD Brian Dolan (me)

Q&A

The webinar portion of the program will be starting at approx. 5:30pm ET. There is currently no audio until we start.

We are on mute and will be starting in a few minutes.

Email dolanb@pepperlaw.com if interested in receiving a CLE form.

What Is Merchant Cash Advance?

Merchant Cash Advance is a specialized form of accounts receivables factoring—

- “Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.”

Wikipedia.

- “Purchases and sales of future receivables and sales proceeds are common commercial transactions expressly contemplated by the Uniform Commercial Code.” *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), *6 (N.Y. Sup. Ct. Mar. 10, 2017).

What Is Merchant Cash Advance?




If appropriately structured, Merchant Cash Advance is not a loan—

The rudimentary element of usury is the existence of a loan or forbearance of money' . . . [T]here can be no usury unless the principal sum advanced is repayable absolutely.'

Colonial Funding Network, Inc. v. Epazz, Inc., 2017 U.S. Dist. LEXIS 70747, *7.

What Is Merchant Cash Advance?

If appropriately structured, Merchant Cash Advance is not a loan—

- **Purchase and Sale Agreement** for the purchase of future receivables
- **Purchase Price: \$2 million**  **Purchased Amount: \$3 million**
(Amount is delivered as receivables come into being and are paid)
- **Specified Percentage:** e.g., 15% of all paid receipts collected each day
- **Specified Daily Amount:** To ensure even cash flow the parties estimate that 15% of paid receipts equals \$10 thousand
- **Reconciliation:** Either party can request a periodic “true-up” to ensure that 15% of paid receipts continues to equal \$10 thousand and will adjust
 or 

NY Courts Have Created Rules For Sorting MCAs From Loans

LG Funding, LLC v Snowstar, Inc., 2017 N.Y. Misc. LEXIS 5190, 2017 NY Slip Op 32741(U) (N.Y. Sup. Ct. Dec. 7, 2017)

Analysis

- Court denied Plaintiff Snowstar's motion for summary judgment based on two 2017 New York Supreme Court cases: *K9 Bytes, Inc. v. Arch Capital Group* and *IBIS Capital Group, LLC v. Four Paws*.
- Citing *K9 Bytes*, the court identified three factors as decisive as to whether the MCA agreement created a loan: (1) whether principal was "put in hazard" versus "in some way secured;" (2) existence of a reconciliation provision; and (3) an indefinite versus a fixed repayment term.
- The agreement described a "purchase and sale;" there was no promissory note or repayment schedule; and the personal guarantees of performance were no broader than the merchant's obligations (i.e. no default for payment shortfall).

MCA Case Law

LG Funding, LLC v Branson Gateways, Inc., 2017 N.Y. Misc. LEXIS 4381, 2017 NY Slip Op 32387(U) (N.Y. Sup. Ct. November 13, 2017) – Cont'd

Analysis

- ▶ “The Agreement . . . does not fall under the exception of being [a] disguised loan because the payment to Plaintiff is based on the receivables earned by the merchant. If the merchant would not make any money, then Plaintiff would not be entitled to any money. And if the merchant would only make a small amount of money, the Plaintiff would only be entitled to a small amount of money based on the percentage set forth in the Agreement.”
- ▶ Branson’s principal owner had executed a personal guarantee of performance covering the “terms and conditions by Branson in the Agreement.”

MCA Case Law

Key factors for sorting MCAs from loans under New York Law :

- ▶ (1) whether principal is “put in hazard” versus “in some way secured;”
- ▶ (2) existence of a reconciliation provision; and
- ▶ (3) an indefinite versus a fixed repayment term.

MCA Case Law

Courts in other states may or may not follow the New York factors:

But another important provision of the agreement is consistent with a loan and not a factoring agreement. The agreement . . . defines default broadly to include [Merchant's] violation of 'any term or covenant in this agreement.' Upon default, [Merchant] must pay to [MCA Provider] 'the full uncollected Receipts Purchased Amount plus all fees due under this Agreement . . . immediately.' This provision shifts all risk of non-collection of receivables to [Merchant] . . . [and makes] the transaction to be a financing arrangement and not a sale.

Anderson v. Koch, 2019 Minn. App. Unpub. LEXIS 205, *11-12 (Minn. Ct. App. March 18, 2019)

MCA Case Law

Courts in other states may or may not follow the New York factors:

The contracts at issue here also contain a variety of provisions allowing Defendants to 'call' the loan . . . Defendants to require restaurants to immediately repay fifty percent of outstanding credits when, among other things, Defendants deem themselves 'insecure,' the restaurant makes any material modifications to its menu, prices, type of food served, theme of the business, or the hours of operation. . . Defendants retain the almost unfettered right to rescind the transaction and receive, at a minimum, its 'purchase price.'

Bistro Exec., Inc. v. Rewards Network, Inc., 2006 U.S. Dist. LEXIS 100770, 2006 WL 6849825 (C.D. Cal. July 18, 2006)

MCA Case Law

Courts in other states may or may not follow the New York factors:

“Having now reviewed the documents defendants provide, the Merchant Agreement appears to be at a usurious interest rate.”

Saturn Funding, LLC v. NRO Boston, LLC, No. CV 16-2523B, 2017 WL 836547, (Mass. Super. Feb. 21, 2017).

MCA Case Law

Courts in other states may or may not follow the New York factors:

- The security agreement and personal guaranty come into effect only in the event of default by Cornerstone, which addresses such significant situations as Cornerstone going out of business, selling its assets, not making its receivables available to LG, or otherwise harming LG's interest. Under the terms of the parties' agreement, LG does not have a right of recourse.
- LG's failure to perfect its security interest means the debtor retained its rights and title to the accounts, so they are property of the bankruptcy estate.

Official Comm. of Unsecured Creditors v. LG Funding, LLC (In Cornerstone Tower Servs.) 208 Bankr. LEXIS 3562 (Bankr. D. Neb. November 9, 2018).

MCA Case Law

Confessions of Judgment:

- ▶ *Champion Auto Sales, LLC v Pearl Beta Funding, LLC*, 159 A.D.3d 507, 69 N.Y.S.3d 798, 2018 N.Y. App. Div. LEXIS 1648 (N.Y. App. Div. 1st Dep't March 15, 2018) — Confession of Judgement Upheld
- ▶ *Wilkinson Floor Covering, Inc. v Cap Call, LLC*, 2018 N.Y. Misc. LEXIS 1845, (N.Y. Sup. Ct. May 16, 2018) — Confession of Judgement Upheld
- ▶ *Richmond Capital Group v. Orion Megivern*, 2018 N.Y. Misc. LEXIS 6052, 2018 NY Slip Op 33196(U) — Confession of Judgement Not Upheld

Although New York case law is favorable, a recent Bloomberg News investigation generated bad publicity, and there is possibility that COJs could be prohibited by legislative action at the federal or state level.

MCA Case Law

- Whether the merchant's filing for bankruptcy constitutes a default. *IBIS Capital Group, LLC v Four Paws Orlando LLC*, 2017 N.Y. Misc. LEXIS 884, 2017 NY Slip Op 30477(U), *7 - *9 (N.Y. Sup. Ct. Mar. 10, 2017).
- Whether the agreement is drafted in understandable terms. *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 2017 N.Y. Misc. LEXIS 1903, 2017 NY Slip Op 27166 (N.Y. Sup. Ct. May 4, 2017); *Korea Week, Inc. v. GOT Capital, LLC*, 2016 U.S. Dist. LEXIS 60646 (E.D. Pa. May 27, 2016).
- Whether requiring arbitration is unconscionable. *Captain Bounce, Inc. v. Business Fin. Services.*, 2012 U.S. Dist. LEXIS 36750 (S.D. Cal. March 19 2012).

MCA Case Law

Bad facts can undermine an MCA contract –

- *Pearl Capital Ravis Ventures, LLC v RDN Constr., Inc.*, 54 Misc. 3d 470, 41 N.Y.S.3d 397, 2016 N.Y. Misc. LEXIS 3945, 2016 NY Slip Op 26344 (N.Y. Sup. Ct. Oct. 25, 2016) (In testimony plaintiff's Chief Risk Officer was unable to describe a single example of a situation in which plaintiff would confront the non-recourse risk of non-payment.)
- *Bistro Executive, Inc. v. Rewards Network, Inc.*, 2006 U.S. Dist. LEXIS 100770, 2006 WL 6849825 (C.D. Cal. July 18, 2006) (Plaintiff's policies, procedures, and job descriptions were identical to, and indistinguishable from, those of a traditional lender. And, internal emails commonly referred to MCA as "lending.")

California Disclosure Law

- ▶ In September 2018 Governor Brown signed SB 1235 into law, which requires disclosure of an APR for various types of “commercial financing” transactions
- ▶ By its terms SB 1235 covers MCA
- ▶ The new law was to the Department of Business Oversight for rulemaking on December 4, 2018
- ▶ Rules have yet be issued regarding how to disclose an APR for MCA

MCA Participations and Securities Law

MCA Participations and Securities Law

1. Why is this important?
2. You represent whom?
3. You must respect (fear?) Section 29 of the Securities Exchange Act of 1934, as amended.

What Is A Syndication?

- ▶ Debts issued by a consortium of lenders to a sole borrower.
- ▶ There is a “lead lender” or arranger for each consortium.
 - Lead is responsible for facilitation of the loan and allocating cash flows to the other consortium members.
 1. Underwritten deal
 2. Club deal
 3. Best-Efforts Syndication Deal

Partnership?

- ▶ '40 Act issues and Advisers Act Issues??
- ▶ Tax Issues
- ▶ Does holder have debt or equity?
- ▶ Who has custody of the assets? Do they have legal competence?

Participation?

- ▶ 2.4. The Participant shall have no interest in any property taken as collateral for any other loans or extensions of credit made to or for the Borrower by Lender, or in any property in the possession or control of Lender, or in any deposit held or other indebtedness owing by Lender, which may be or become available for payment of the Advances by reason of the general description of secured obligations contained in any security agreement or other agreement or instrument held by Lender or by reason of the right of set-off, counterclaim or otherwise, except that if such property, deposit or indebtedness or the proceeds thereof shall be applied in reduction of the amount of Advances outstanding under the Loan Agreement then the Participant shall be entitled to its proportionate share in such application.
- ▶ 2.5. If Participant shall obtain any payment (whether voluntary, involuntary, through the exercise of any right of banker's lien, set-off, or counterclaim) on account of Participant's Participation in the Advances in excess of Participant's Participation Percentage of such payment on account of the Advances, Participant shall purchase from Lender and such other persons or entities to which Lender shall have sold Participations in the Advances (such other persons and entities, together with Participant and Lender, being referred to as "Participating Entities") such additional participation in the Advances as shall be necessary to cause Participant to share such excess payment ratably with the Participating Entities, provided that if all or any portion of such excess payment is thereafter recovered from Participant, such purchase shall be rescinded and the purchase price restored to the extent of such recovery (but without interest).

What Is A Participation?

“Participations are not loans; they are contractual arrangements between a lender and a third party, in which the third party, or participant, provides funds to the lender. The lender in turn uses the funds from the participant to make loans to the borrower.” If the agreements are “true participations,” [citations omitted] and thus sales rather than loans, then the funds are effectively removed from the res. of the estate.”

Rothenberg v. Oak Rock Fin., LLC, 14-cv-3700, USDC, EDNY (March 31, 2015).

Elements of A Participation

1. Money is advanced by participant to a lead lender;
2. A participant's right to repayment only arises when a lead lender is paid;
3. Only the lead lender can seek legal recourse against the borrower; and
4. The document is evidence of the parties' true intentions.

Rothenberg.

Factors That Signify A Debtor Creditor Relationship

1. Guarantee of repayment by the lead lender to a participant;
2. Participation that lasts for a shorter or longer term than the underlying obligation;
3. Different payment arrangements between borrower and lead lender and lead lender and participant; and
4. Discrepancy between the interest rate due on the underlying note and interest rate specified in the participation.

Participation or Loan?

“The most determinative factor of all of these is the risk allocation involved in the transaction. If the participant does not bear the same risk of loss as the seller, or if the seller has made a guarantee of payment to the participant, the transaction [*28] is generally considered a loan and not a sale.” *In re Corporate Financing, Inc.*, 221 BR. 671 (Bankr. E.D.N. Y. 1998). “In a typical participation agreement, the lead lender makes no warranties or guarantees about the borrower's ability to repay the underlying loan. Thus, an indicium of a loan is the guarantee of repayment by the lead lender to a participant.” *In re Sackman Mortgage Com.*, 158 B.R. at 933.

Participation or Loan?

Where an investor receives “no contractual guarantee of repayment or compensation” in the case of the borrower’s default, “[s]uch assumption [*39] of risk strongly suggests that the [investors [are] not in a creditor-debtor relationship with [Lender].”

In re Golden Plan of California, Inc., 829 F.2d at 709-10.

What Is A Security?

- ▶ Howey test
 - investment of money
 - in a common enterprise
 - with the expectation of profit
 - from the efforts of others

Questions & Answers

Q&A

Cisco Webex Events

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Q&A

Email dolanb@pepperlaw.com if interested in receiving a CLE form.

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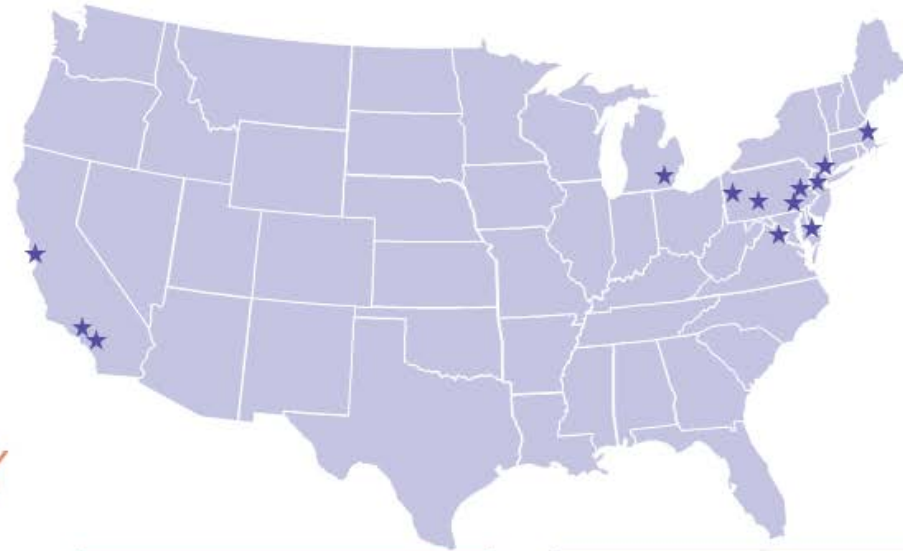
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